City of Lincoln Nebraska
Police and Fire Pension
Summary for 05/06/99 Advisory Committee Meeting

Members Present: Dennis Duckworth, Alan Townsend, Al McCray, Don Mathes, Aaron Drake.
Members Absent: Jim George
City Staff: Paul Lutomski
Others: None

Dennis Duckworth: Meeting is called to order. Motion to approve the November minutes?

Al Townsend: So moved.

Alan McCray: Second.

Dennis Duckworth: All in favor?

Dennis Duckworth, Alan Townsend, Al McCray, Don Mathes, Aaron Drake: Aye.

Dennis Duckworth: Opposed? (silent) Motion carries. Recent activities Paul?

Paul D. Lutomski: John Cripe is not here today because he is working on a document for Mayor Wesley. Mayor Wesley asked all the directors to give him a document listing projects and concerns that need to be addressed. John is working on the items pertaining to the pension, labor negotiations, departmental re-organizations, and compensation.

The big topic for this meeting is the DROP cost estimate. We received the cost estimate from our actuary firm and the cost was not neutral. In fact it was about $5 million initially plus about a 1% increase to normal cost for each year in the future. We are working with them to try to get the DROP cost closer to cost neutral. With that said let me backtrack. On pages 10 and 11 is our letter to Gabriel Roeder Smith, our actuary, requesting them to cost the DROP and to cost another opportunity to switch from the 7% and 7.6% plans to the 8% plan. We have not heard from them regarding the switch cost. Pages 12 - 19 is the DROP costing report. The DROP cost is derived from the assumption that members will enter the DROP at an earlier age than the age they would have retired if the DROP was not offered.

Don Mathes: What's the basic concept of the DROP, and how does it interact with the other pension benefits?

Paul D. Lutomski: There are three different pension plans. One members contribute 7% for 21 years and then stop contributing. These members can retire at age 53 and 21 years of service and are paid 54% of their highest consecutive 26 pay periods of pay. If they work up to age 58 and 26 years of service they are paid 64% as the maximum. We get paid every two weeks, so 26 pay periods is 52 weeks. The second plan is one where members contribute 7.6% for 21 years and then stop contributing. These members can also retire at age 53 and 21 years of service and are paid 58% of their highest consecutive 26 pay periods of pay. If they work up to age 58 and 26 years of service they are paid 68% as the maximum. The third plan is one where members contribute 8% for their entire career. These members can retire at age 50 and 25 years of service and are paid 64%. 64% is the maximum. All the plans offer early retirement at age 50 and 21 years of service.

The 7% and 7.6% plans offer a refund of the members accumulated contributions and interest when the member retires. The monthly annuity is actuarially reduced by the amount of the refund. The 8% plan does not pay a refund.

John Cripe first heard of a DROP at a pension conference. A DROP is best suited to a traditional style defined benefit plan, like the 8% plan, that does not offer a lump sum refund. DROP is an acronym for Deferred Retirement Option Plan. It is a way for a defined benefit plan member to accumulate a lump sum for retirement. The way our proposed DROP would work is that a member would enter the DROP and retire as far the pension plan is concerned, but not retire and keep working as far as their department is concerned. The member's monthly pension benefit is deposited into their DROP account. They self-direct the funds with a third party company. The member must retire-in-fact from their department within three years of entering the DROP. When the member retires-in-fact their same monthly pension is paid to them rather than their DROP account. If the member gets a pay raise their pension benefit does not increase because they are retired as far as their pension is concerned. If a member becomes disabled, they do not get disability pension benefits because they are retired as far as their pension is concerned, but their monthly pension is paid directly to them rather than to their DROP account.

Don Mathes: I get the picture.

Paul D. Lutomski: The DROP costing report begins on page 13. There is a mistake about 6 lines down. December 29, 1998 should be August 31, 1998. This is the date of the last actuary report. All the assumptions used in that report are used in the DROP costing. (reads report) The next page describes eligibility to enter the DROP. We plan on changing the "Plan A" eligibility to match the "All Other Plans" eligibility. Changing "Plan A" eligibility to have a cut off date for DROP entry will decrease the cost of the DROP plan.
(reads report) Page 16 shows the retirement patterns currently used for the annual actuary analysis. These are the patterns that are expected to increase when the DROP is added. For example, without a DROP it is expected that 35% of Police in Plan A that are age 50 will retire. Once the DROP is added the pattern is expected to increase to be 40% of Police in Plan A that are age 50 will enter the DROP. The increase in retirement patterns are described on page 17. If the retirement patterns do not change at all, the cost of the DROP would be neutral. The DROP's effect on retirement patterns drives the estimated cost of the DROP. If we think the increases will be less than those shown in the report, the next time the DROP costing is run, we can use our increases and the report will have a lower DROP cost estimate. The problem with this report is that there is no control group to compare the DROP's actual effect on retirement patterns. Any change to the retirement patterns could be used for the estimate and no one will ever know how close the estimate was to the real cost.

Page 18 is full of cost estimate numbers. The numbers are grouped by the three plans, then an all plan total, then a worst case scenario where all Plan A members DROP at age 50 and 25 years of service. The first column labeled "NC" is normal cost as a percent of salary. For example, the Plan A grouping has a normal cost of 1.66%. This is the increase to normal cost resulting from the increase to the retirement pattern. The next column shows $1.4 million. This is the cost to provide the DROP to current members. The actuary explained it to me as follows: For all the current members, the normal cost has been about 19% of payroll for their entire career. If the DROP were around for all that time in the past, the normal cost would have been 19% + 1.66%, or 20.66%. The DROP cost is retro-active for all the current members, so the $1.4 million is the 1.66% of salary for all those members for all their previous years of service. The next column is the amortization period to pay for the $1.4 million. If it is paid off over six years normal cost would increase by 3.65% of salary. The 1.66% is a also a normal cost that needs to be paid in the future, so adding the 1.66% to the 3.65% gets 5.31%. At the current 8/1/98 salary for Plan A members this is $374,105 for the first year. In reality the $1.4 initial cost would not be amortized, it would just be used to decrease the pension's overfunding. Then normal cost would be increased by 1.66%. Down to the "All Plans – Total" group the total initial cost is $4.9 million and a 0.9% increase to normal cost. The $4.9 million initial cost and the 0.9% increase to normal cost are a problem.

On the next page the actuary gives some ideas to decrease the DROP cost. In Comment 1 they mention DROPing less than 100% of the member's benefit. For example, if 95% of the member's benefit were to be DROPped, a member receiving a $2,000 monthly pension would have only 95% of it, or $1,900 deposited into his DROP account. The pension plan would keep the $100 to offset the cost of the DROP. When the member exits the DROP they are paid the full $2,000. We don't like that idea, but the actuary says it is the most common way to decrease the cost of a DROP.

Don Mathes: What are the DROP percents used by some other pensions?

Paul D. Lutomski: I don't know. I can ask our actuary. They also mention accruing interest on the DROP account at a rate less than the actual rate earned. We don't like this either. We had planned on letting members self-direct their DROP accounts.

(reads Comments 2 and 3) Comment 4 has other variables. The first bullet point is moot point because member's will not be allowed an annuity withdrawal if they want to DROP. The second bullet point asks when contributions stop. For purposes of this report they stop as soon as the member enters the DROP.

Dennis Duckworth: The cost of the DROP would be decreased if members continued their regular contributions, if any, during the DROP period.

Al McCray: That's the same as DROPping less than 100% of the member's benefit into their DROP account. The net result to the member is the same.

Dennis Duckworth: Members are already used to contributing a portion of their pay, but are not used to taking a lower pension amount.

Paul D. Lutomski: It may be a better way to "market" the cost.

> On Monday 5/10/99 during a telephone conversation with Jim George regarding the meeting, Mr. George offered another way to decrease the DROP cost: to make the DROP available to members after they are eligible for <u>regular</u> age and service retirement, rather than after <u>early</u> age and service retirement.

Regarding the DROP cost, our plan is to have Gabriel Roeder Smith review the valuation assumptions. This has not been done for over 10 years and needs to be done regardless of the DROP. Valuation assumptions are all the assumptions mentioned in the annual actuary report, such as the 4% annual salary increases, the 7% return rate, the retirement patterns shown in this report, etc. After that review is completed the variables specific to the DROP need to be addressed, such things as the increase to the retirement patterns, as well as the design of the DROP. As I said, we plan on changing the eligibility for Plan A to be the same as the other plans, to put an end date on Plan A eligibility. We can also look at other ways to decrease the cost of the DROP. The review should be done about mid June. Then we should have a special meeting to discuss the DROP variables and DROP structure. Dennis, would you be willing to accept a motion for a specially scheduled meeting for this?

Dennis Duckworth: Would anyone like to make a motion for a special meeting to discuss the DROP when the review is completed?

Al McCray: I'll make a motin to that effect.

Aaron Drake: Second.

Dennis Duckworth: Discussion? All in favor? (ayes) Motion carries. Paul?

Paul D. Lutomski: The pension sold $200,000 and then $800,000 of the same bond to pay for lump sum retirement refunds. We also had three call date duration swaps. The details of all these transactions and reasons for them are listed in the memos on pages 26 to 30. On pages 31 to 37 is an example I made for Aaron. I included it to reinforce the point that members taking a refund of their account value must make 6% annual return on that refund every year to equal what the pension would have paid them without a risk. To get a 6% return a member would have to take some risk. The pension also pays a remainder to the member's estate if the member, and their beneficiary, do not live to receive all the members account value through pro-rated monthly payments. Aaron?

Aaron Drake: This came about as I was helping a couple fire fighters analyze their pension statements in their process for retirement planning. The question arose if a member could take their lump sum refund and roll it into an annuity that would pay a monthly amount, when added to their monthly City pension, that would equal or exceed the amount the City would have paid them had they not taken a refund. I'll qualify this by stating it was a non-variable basis, or fixed annuity, at today's interest rates and today's mortality tables. I couldn't find anyone in the country who could beat the City payout. Even going on a brokerage basis, with some pretty small companies, with what I would not call acceptable ratings. Only one company was basically about able to match the difference. I wondered what annuitization tables we were using that we were paying higher than anyone in the whole country. That's why I asked Paul to run an analysis for me to make sure this isn't an anomaly. It was also true for myself.

Paul D. Lutomski: Because we did not have a February meeting, for Al (McCray) and Don (Mathes) I included a copy of the letter we sent to member's with their annual pension statements.

Page 40 is an economic forecast from First Tennessee Bank. It shows 30 year bonds at 3.5% in the year 2000. Page 41 is a copy of a "Pension and Investments" Magazine article regarding stock market expectation. The experts cited here predict low returns, 5% to 8.75% for stocks over the next 10 to 20 years. To boost returns they recommend considering international stocks. International stocks have underperformed relative to the domestic S&P 500 stocks. If we can invest more in equities, international might be a good place to consider.

Don Mathes: Do you have this Ibbotson report? (referred to in the article)

Paul D. Lutomski: No.

Don Mathes: That would be an excellent service for you to buy because they have tremendous statistics about investment returns, and they're independent. Not brokers or investment managers. I think you could probably find it in the City library if you wanted to look at it before buying. It’s a little bit expensive, but in my opinion it’s the best authority you can use in projecting rates.

Paul D. Lutomski: I’ll look into that.

Don Mathes: You could probably get Wilhsire information from the state investment officer. They pay Wilshire a lot of money every year. They do consulting work for more pensions than anybody else, I believe. They are better statisticians than rate forecasters. They see what a lot of other pensions, like the state of California, are doing. If you wanted to hire a consultant Callan Associates are in Kansas City. They would probably be less expensive than Wilshire because they are closer and there would’nt be as much first class travel to pay for.

Paul D. Lutomski: The advances in the market are getting more concentrated in the big domestic companies. Do you have any insights on that?

Al McCray: I saw if you remove the top 10 or 15 companies from the S&P 500 you get a return of about 3%. That shows diversification is necessary.

Don Mathes: Recently there has been a shift where different stocks are carrying the load more.

Paul D. Lutomski: The asian countries seem to be coming out of their slump.

Don Mathes: If you go into the foreign markets you’re taking on a whole new kettle of fish. There have been some fantastic returns and probably will be again, but there have also been some real disasters.

Al McCray: It used to be said that in Korea they carried six or seven sets of books showed you whatever your interest was. For instance, one set if you were interest in leverage, another for income growth etc. They were not using internationally accepted accounting principals.

Paul D. Lutomski: We would have to pick a professionally managed fund if we were to invest new funds internationally.

Al McCray: I’m sure there are very well run funds.

Don Mathes: There are index funds that are very inexpensive. They track perfectly with indices such as the Standard and Poors 500.

Paul D. Lutomski: The pension has half its equity money in the Vanguard Index Trust 500, which tracks the S&P 500. It has out performed all of the pension’s other equity funds. The price to book ratio of this fund is the highest of the funds owned by the pension. That means it has the possibility of falling the most.

Don Mathes: The expense ratio is very low. About 19 basis points.

Aaron Drake: I think Vanguard also has a preferred S&P 500 which has the best 30% of the S&P stocks.

Don Mathes: Whenever you have a limited part of an index move better than the average, somebody will design a fund to track that portion.

Paul D. Lutomski: We received something from Vanguard a couple of weeks ago that they have a set of funds with ultra low expense ratios and high minimum investments. The S&P 500 account was about 10 basis points expense and $10 million minimum. The pension also has Vanguard's Extended Market Index, which tracks the Wilshire 4500, and we have the Vanguard Small Cap Index which tracks the Russell 2000. In the American Funds Group the pension has Washington Mutual, ICA, Growth, Small Cap World and EuroPacific Growth Fund.

Dennis Duckworth: I noticed on the yellow graph sheet that the equities are positive year to date and the debt assets are negative. Debt assets drive the pension's returns.

Paul D. Lutomski: Yes. John plans to talk with Mayor Wesley about increasing the pension's equity allocation to 30%. Pages 42 to 44 are the 12 months cash flow analysis, and pages 45 to 48 are the 10 year cash flow. The last page is a color graph of values the pension will be paid at the earlier of maturity date, call date of begin pay date. We are not planning any debt investments over the next twelve months. If Mayor Wesley allows the pension to buy more equities we'll sell some debt investments to do that. I'm done. Any questions or concerns you would like me to relay to John?

Al McCray: (To Paul) Do you think Don Wesley will be more receptive to increasing the City's contribution every year?

Paul D. Lutomski: I don't know. I have never met him. Perhaps these guys (gesturing to Dennis Duckworth, Al Townsend, and Aaron Drake) would know better.

Dennis Duckworth: Hopefully he'll be willing to listen.

Aaron Drake: To be fiscally responsible.

Don Mathes: I would expect he would try hard to do what you ask him to do.

Al McCray: The increase was?

Paul D. Lutomski: From about $450,000 to $900,000 effective last September. We have asked for an additional $200,000 each year, and have the budget officer's support, but it depends on the Mayor's budget and council approval.

Dennis Duckworth: Any other business? If not I'll entertain a motion to adjourn.

Aaron Drake: I'll make a motion to adjourn.

Al Townsend: Second.

Dennis Duckworth: All in favor?

All: Aye.

Dennis Duckworth: Meeting adjourned.